



# Premier Business Advisors

## **Sell Your Business!**

By Tom Glendenning

*Every business that is for sale has competition from other businesses on the market. Buyers will look at businesses that have the best ratio of Asking Price/Earnings. The internet has made these searches easy and convenient for buyers. Businesses that have ratios much higher than others will not be considered. Those that are priced right will usually sell.*

Buying or selling a business is a very complex transaction. **Two thirds of all businesses that are for sale do not sell. Why?** It's because the seller's and buyer's expectations are very different. To successfully buy or sell a business both the buyer and seller need to be flexible. They must consider a number of new ideas and see those ideas from the other's point of view.

Like a house, a business should look its best when it is for sale. The accounting should be in order, all equipment repaired, unused or broken equipment removed, and the business dressed to look good when a buyer visits. Buyers will even walk away from a good profitable business if it looks bad. Good packaging, like that utilized at Premier Business Advisors ([www.pmbizbrokers.com](http://www.pmbizbrokers.com)), is critical to getting a business evaluated and brought to the "top of the stack."

### **The buyer wants income, not promises**

Buyers take a risk and invest in an existing business because they want a new lifestyle and a respectable income immediately. Very few are willing to delay gratification of those desires. Buyers willing to delay profitability start their own businesses or purchase a new franchise outlet with expectations of profitability after a period of time. If a buyer states "I don't think this business is right for me," it often indicates that the business does not generate enough income. Often sellers don't recognize this as a valid criticism of their proposed deal. The value of a business is what the market (buyer) is willing to pay for it, not what the seller expects to sell it for. Successful sellers are those who are flexible and accept the market's value.

Most buyers plan on purchasing a business and taking an income from that business immediately. They don't want sellers or brokers telling them what they will receive after they increase sales, lower expenses, or develop the potential of the business. Buyers don't understand why the seller didn't develop the potential of the business while he or she owned the business. *If the business has great potential why are you selling it? You could sell the business for so much more if you developed the potential.* Every seller believes their business has tremendous potential but buyers are NEVER willing to pay for potential. They believe that if the business could be grown, the seller would have done it.

## **The relationship between operating profit and asking price**

A cash purchase of a business is the exception rather than the rule. Buyers will make a down payment and begin a long-term monthly payment schedule with someone. The money for the down payment will often come from equity in their home.

The buyer and the business might be eligible for an SBA guaranteed loan from a lending institution. Many times the buyer must obtain financing from the seller with a “seller carry” promissory note. When the buyer takes over the business, the business should provide enough operating profit to be able to service the debt and provide a living for the buyer. That means that the business must first cover fixed expenses, rent, utilities, cost of product, and labor. After all these expenses are paid the remaining amount is operating profit which must cover debt payment and the new owner’s income.

For example, the *Burger Barn* has annual gross revenues of \$382,600. After paying for all costs of producing the product (known as cost of goods sold or cost of sales), the fixed expenses (including rent and utilities), and all salaries (including insurance, payroll taxes, and the like), there is an annual operating profit of 10.5%, or \$40,200.

This income is not enough to cover both a return to the buyer and note repayment. If the buyer paid \$200,000 for the business, put 20% (\$40,000) down and had a balance of \$160,000 financed by the seller with a 10 year note at 10% interest, the annual payments are \$25,400.

The buyer uses \$25,400 out of his profits of \$40,200 per year to pay the promissory note to the seller. The operating profit of \$40,200 is reduced to an income of \$14,800. This is not an adequate income for the buyer: The price was too high.

Buyers look for businesses that meet their financial requirements. Every business that is for sale has competition from other businesses on the market. Buyers will look at businesses that have the best ratio of Asking Price/Earnings. Businesses that have ratios much higher than others will not even be considered. Those that are priced right will usually sell.

**OVERPRICED BUSINESSES DO NOT SELL!** This is proven statistically and is a marketplace fact.

For a business to sell it must be transferable, that is the buyer must be able to achieve success in his role as the new owner. When a buyer takes over the business and doesn’t have adequate income to make payments on the note to the seller, both the buyer and the seller have a big problem. Some sellers will want to take back the business. The seller needs to consider these two points:

The purpose of selling the business is to allow the seller to be paid and start a new life, retire or move on to other activities, not return to the business.

In some instances the seller may find after taking back the business that it has been mismanaged and it may take years (if ever) to recover.

When a seller has to take back a business it may be worth much less than what the buyer originally paid and may not carry the same marketplace value. Taking back a business is never a good idea, and should be avoided by pricing properly in during the initial sale.

## Methods of valuation – determining a range

There are many ways to determine a value for a business such as: gathering market comparable data, return on investment, marketability assessment and net asset value. No matter what methods are used, they should take into consideration the industry, barriers to entry, license requirements, regulatory issues, the cost of product, labor, rent, equipment capability and age, competition, parking, other business opportunities, market value fluctuations for buildings, lease, location, size of down payment, the terms of the note, and possibly other factors depending on the type of business and its position in the marketplace.

A business in a rural area is less attractive many buyers because a larger metropolitan area provides a better opportunity for the spouse to have a job, schools for the children, shopping and entertainment. The buyer pool will also be lower, due to the reluctance of many buyers to relocate. Establishing a selling price without considering the buyers perspective will make it impossible to negotiate a successful sale.

## The business must pay for itself and provide a livable income

To be realistic and successful any determination of the business' value must consider the buyer's income.

When one buys a business, the business must provide personal income. Unless the buyer paid cash for the business that income must be able to meet the payments on the note(s) or the sale will fail. A responsible seller will set an asking price and establish a note payment structure that the business' operating profit can support. If the seller doesn't do this, it makes the sale of the business highly unlikely or impossible, and the business will not sell.

If your business shows no operating profit or shows a loss you will have to prove that your business could and will be profitable if it is properly managed. To do this you will need to develop a pro-forma which shows that if the buyer brings the cost of product, labor and other expenses within industry standards it would be profitable. This is a turnaround situation and most buyers will be unwilling to even look at it, but someone with specific industry experience may be willing to buy the assets and give it a try.

## Sellers earned equity vs. buyers earned income

Some sellers contend that they should base the business asking price on future profits. This is how new franchise units and some new start up businesses are priced. These are very risky investments. 90% of all new businesses fail within two years. Franchises are more successful, but still have failures with many units not producing profitability. Buyers of existing businesses almost NEVER pay for future profits. The seller gets a sale price based only on what the business has earned. The seller's equity is based on building the business as the owner. The buyer is paying a price for the business based on that business' past and current profitability. Any additional profit the buyer will earn is from what he or she puts into the business after taking it over.

Here is another example: *Burger Barn's* chief competitor, *Bob's Burger Emporium*, is better managed and is paying less rent for its premises. *Bob's Burger Emporium* has larger annual gross revenue of \$427,000. When Bob pays for all of the costs of product, fixed expenses, and salaries, he has an

operating profit of 20%, or \$85,500, more than two times that of Burger Barn. The value of Bob's business, based on a higher operating profit, provides additional earned equity.

Bob's business value is much different than *Burger Barn*. Due to better management and lower expenses Bob has built more equity into his business and can justify a much higher asking price than *Burger Barn's* owner. *Bob's Burger Emporium* will have more income to meet note payments from and provide the new owners with an annual income. If the sales price is \$300,000, the buyer puts 20% down, or \$60,000, and has a balance of \$240,000 financed by the seller at the same terms as *Burger Barn's* sale, the annual payments are \$38,000. Deduct this from the \$85,500 operating profit and the buyer gets \$47,500 per year, enough to live and pay the note comfortably. The sale price made sense to the buyer, and any buyer comparing the two would have bought *Bob's Burger Emporium*. The *Burger Barn* will never sell on these terms. The ratio of selling price to income is much better for the *Burger Emporium*, and it can capture a much higher price even though revenues are only 10% higher than the *Burger Barn*.

## **Liabilities of the seller after purchase**

When you started your business, you signed a long-term lease for the premises, usually for five years with options, you may have signed a franchise agreement for 10 or 20 years, and you may have signed leases or contracts for the use or purchase of equipment. In addition, you may have obtained financing from a bank or other lending institution and you signed a promissory note. You may have established a corporation or LLC that you believe is responsible for most of those obligations. In most cases you have probably signed all the paperwork as an individual as well. Landlords, banks, and equipment vendors will not allow the corporate signature without a personal guarantor. Even after a sale you may remain responsible until all the obligations are met.

## **Adjusting expectations**

Both parties, the buyer and the seller, must remain flexible about the terms of the deal or negotiations will fall apart. As the seller, you must understand the buyer's income needs and adjust your expectations about the value of your business. The buyer must remain flexible and adjust his/her expectations about the immediate income he/she may receive from the business's operating profit and the amount available for working capital requirements.

Buyers typically enter negotiations with a limited understanding and misconceptions about the business. They fear what they do not know. Buying a business is risky. The seller must be able to put the buyer at ease. The seller should anticipate buyer questions and provide answers that make sense. The seller must not hide any information and disclose everything they know. Hiding information is illegal and can cause serious harm to both the buyer and the seller.

The buyer is going to have a number of ideas for the business. He or she may want to change the look of the business, add or change personnel or upgrade or replace equipment. The buyer will expect the current owners to offer their comments about these changes. The buyer will also want the seller's opinion of how to increase sales and profits. If a buyer wants substantially more income per year than your business can provide at its maximum potential then it is not the right investment. Both the buyer and the seller must be willing to adjust their expectations to make the potential sale a reality.

To make the deal a reality the buyer needs sufficient funds to pay any notes and all other expenses both in boom and bust economic times. The seller's goal is to maximize his or her earned equity. The seller

must remember the sale is not complete until the note is paid. If the deal is financed by a lending institution the lender will determine the maximum amount they are willing to lend, based on the operating profits of the business, typically with a 25% to 30% down payment. The lending institutions will also make sure the margin between the note payments and the operating profit is not too narrow. A margin that is too narrow is not a sale; it is a gamble. A bad month, management errors, a key employee who leaves and is difficult to replace, or a significant client leaving could impact the repayment ability of the borrower. A seller must be careful not to let greed override his or her logic and prevent the sale of the business.

## **Competition from other businesses for sale**

When you offer to sell your business you are in competition with other businesses that are for sale. Buyers are savvy and will shop for the best deal they can find. They will look at your sales price, income and compare them to other businesses. The internet has made these searches easy and convenient for buyers. If your business is overpriced compared to the other businesses for sale, buyers will never make even make a phone call or send an email about the business. If you overprice, your business will not sell and potential buyers will never realize the potential they might have by purchasing your business because they will never even consider it.

## **Summary**

- Buyers are interested in an immediate and dependable income based on the current business profits and the profit as it exists the day it is purchased.
- A pricing formula, to be valid, must consider the buyer's income.
- Your business must be priced right to be competitive.
- The seller's earned equity is in the selling price. Any growth of the business and its profit after the sale is the buyer's earned equity.
- Successful negotiations require adjusting expectations.

### **About the author**

Tom Glendenning is an agent with Premier Business Advisors, a business appraisal and brokerage firm in Northern California and Nevada. For more information please visit the Premier web site at [www.pmbizbrokers.com](http://www.pmbizbrokers.com). The web site has many tools to help both buyers and sellers, including a multipart loan calculator that allows any business seller or buyer to assess whether a deal structure makes sense post-sale.